In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE,
PETITIONER

v.

NATIONAL ALFALFA DEHYDRTING AND
MILLING COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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1. The only issue in this case is whether respondent was entitled to claim deductions for amortizable bond discount upon its issuance of $50 face amount 5 percent debentures in substitution for its eliminated $50 par 5 percent preferred stock. Nevertheless, both respondent (Br. 18-22) and *Amicus* Norton Simon, Inc. (Br. 24-29) have interjected into that issue irrelevant discussions of the tax treatment of respondent's shareholders. In so doing, each misstates the Commissioner's position as dependent upon the reorganization provisions of Sections 368 and 354 of the Code. These two sections, however, are nowhere mentioned in our opening brief and are unrelated to our argument.

In their discussion of the irrelevant tax consequences to respondent's shareholders, both respondent (Br. 20) and *Amicus* Norton Simon, Inc. (Br. 24-26) make much of the Internal Revenue Service ruling issued in advance of the transaction. There, the Commissioner ruled (R. 17-21) that respondent's common shareholders who exchanged $1 par common stock for $3 par common stock would recognize no gain or loss. He further ruled that holders of the eliminated preferred shares who received respondent's debentures would recognize capital gain or loss measured by the difference between the fair market value of the debentures and their cost bases in their preferred shares. The correctness of that ruling is not questioned by either party in this case. Moreover, its conclusions have no bearing on the question whether respondent is entitled to deductions for amortizable discount.

The tax consequences of a transaction involving corporate shares upon the shareholders are rarely reflected in any complementary tax effect upon the corporation issuing the shares. Thus, for example, had the preferred shareholders received cash upon elimination of their preferred shares they would have been required to recognize gain or loss upon the transaction but there would have been no gain or loss to the corporation. Cf. Section 311(a) of the Code. Had the preferred shares had a market value of $50 upon their elimination, the position of respondent and the *amicus* would require them to acknowledge that no discount arose upon the issuance of the debentures. The preferred shareholders would still be required to recognize gain or loss, the amount of which would depend upon their bases in the preferred shares. Thus, the tax consequences of the transaction to the preferred shareholders considered in the Commissioner's ruling have no bearing upon the existence of discount.

One parallel, however, between the discount question and its ultimate effect upon the debenture holders deserves mention. Under Section 1232(a)(1) and 1232(a)(2)(B), the $17 discount per debenture claimed by respondent would, if it existed, give rise to an equivalent amount of ordinary income to the debenture holders upon the sale or retirement of the debentures. If over one-third of the $50 face amount of the debentures were taxable at ordinary income rates under such circumstances, the debenture holders would, to say the least, find such tax treatment surprising. Indeed, the possibility of this tax consequence was nowhere mentioned in the proxy statement (R. 173-181) describing the transaction which both classes of respondent's shareholders approved.

2. Apart from the fact that the tax consequences to the shareholders discussed in the Commissioner's ruling are irrelevant, respondent and *Amicus* Norton Simon, Inc., have both erroneously stated the Commissioner's position is based upon a claim that the transaction at issue was a tax-free reorganization under Sections 368(a)(1)(E) and 354. This assertion is without foundation. Although we have characterized the elimination of respondent's preferred stock and the issuance of debentures in substitution therefor as a "recapitalization," we have nowhere suggested that the transaction would qualify as a Section 368(a)(1)(E) reorganization or that such qualification is a necessary element in our argument. To the contrary, we have employed the term "recapitalization" in its general sense in order to point out that the effect of the transaction was simply a modification of respondent's capital structure. Indeed, respondent's own directors characterized the transaction as "a reorganization of the Company by way of recapitalization" (R. 56).

In order to clarify the confusion generated by respondent and *Amicus* Norton Simon, Inc., we note that the question in this case has no connection with Sections 368(a)(1)(E) or 354. Those provisions govern the tax treatment of shareholders and not of the corporation whose stock or securities may be exchanged.[1] With respect to the tax consequences to the shareholders, the decisions under the 1939 Code consistently held that a similar exchange of a corporation's preferred shares for its bonds was a transaction in which neither gain nor loss was reorganized to the preferred shareholders participating in the exchange.[2] However, in 1954, Congress codified and somewhat expanded this Court's decision in *Bazley* v. *Commissioner,* 331 U.S. 737, and thereby changed the results of these decisions.[3] Under Sections 354(a)(2) and 356(a) and (d) of the 1954 Code, shareholders involved in such exchanges must recognize gain or loss. It was on the basis of those provisions, new in the 1954 Code, that the Commissioner ruled that respondent's preferred shareholders would recognize gain or loss upon receipt of the debentures.

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[1] The tax consequences of a recapitalization to the corporation being recapitalized is in no way affected by Section 368(a)(1)(E). Wholly apart from the applicability of the tax-free reorganization provisions, a recapitalization does not generally produce gain or loss to the corporation because its mechanics do not involve any taxable event. Cf. *Commissioner* v. *Capento Securities Corp.,* 140 F. 2d 382 (C.A. 1).

[2] Cf., *e.g., Hickok* v. *Commissioner,* 32 T.C. 80; *Wolf Envelope Co.* v. *Commissioner,* 17 T.C. 471; *Schoo* v. *Commissioner,* 47 B.T.A. 459.

[3] S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 265, 268-269.

3. Finally, *Amicus* Norton Simon, Inc. (Br. 42-47) seeks support for its position from the legislative history of Section 413(b) of the Tax Reform Act of 1969, 83 Stat. 487, amending Section 1232(b)(2) of the Code with respect to bonds issued after May 27, 1969. It recognizes that if the amended version of Section 1232 (b)(2) were applicable to this case, respondent's claim to discount would be foreclosed. From this fact the *amicus* negatively infers that the government "[i]n essence" urges a retroactive application of the new legislation (Br. 47). The 1969 legislative history, however, offers no support for a claim of discount in this pre-1969 transaction.[4]

The House Ways and Means Committee, presumably referring to the existing conflict of decisions,[5] stated in its Report[6] as follows:

> There is some question under present law as to whether the original issue discount rule applies to a bond which is issued for property, such as stock, which has a value below the face amount of the bond.

The House Bill, applicable to bonds subsequently issued, would have resolved the uncertainty by enacting, in general terms, the rule of the *American Smelting* decision.[7] The Senate Finance Committee concurred.[8] But that was not the end of the matter. In the Senate, a different and contrasting resolution of the uncertain-

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[4] See our opening brief, p. 23, n. 25.

[5] See our opening brief, pp. 21-22.

[6] H. Rep. No. 91-413 (Part 1), 91st Cong., 1st Sess., p. 109.

[7] *Id.*, p. 110.

[8] S. Rep. No. 91-552, 91st Cong., 2d Sess., p. 148.

ty was adopted. The Senate largely rejected the *American Smelting* rule and enacted the rule of the Court of Claims in its *Montana Power* and *Southern Natural Gas* decisions,[9] excepting only cases where the bonds issued were traded on an established securities market or the property acquired was stock or securities traded on an established securities market.[10] The Conference Committee accepted the Senate version,[11] and the bill was enacted in that form. Consequently, with the exceptions noted, Section 1232(b)(2) now provides, with respect to bonds issued after May 27, 1969:

> Except in cases to which the preceding sentence applies, the issue price of a bond or other evidence of indebtedness (whether or not issued as a part of an investment unit) which is issued for property (other than money) shall be the stated redemption price at maturity.

Hence, the general rule of the amendment is that no discount shall arise upon the issuance of bonds for property. This represents in effect a congressional rejection of the *American Smelting* decision. The *amicus* cannot infer that Congress approved the *American Smelting* rule for years prior to 1969 simply by characterizing the Senate changes to Section 1232(b)(2) as having been made in response (Br. 47) "to a last-minute Treasury appeal, on limited practical policy grounds * * *."

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[9] See our opening brief, p. 21.

[10] Neither respondent's preferred stock nor its debentures were traded on an established securities market.

[11] H. Conf. Rep. No. 91-782, 91st Cong., 2d Sess., pp. 135-136, 307-308.

Thus, from the legislative history, it appears that:

(1) Section 1232(b)(2), as amended, is applicable only with respect to bonds issued after May 27, 1969. For that reason it is inapplicable to the debentures issued by respondent. Congress did not purport to resolve the uncertainties concerning bonds issued prior to the effective date of the amendment.

(2) Insofar as the congressional resolution may be deemed significant as a guide to the resolution of questions with respect to obligations issued prior to May 27, 1969, it rejected, with limited exceptions inapplicable here, the rule of the *American Smelting* case for which respondent and the *amicus* supporting it contend.

The legislative history of the Tax Reform Act of 1969, therefore, offers no support to the position of respondent and *amicus*. We do not assert that the 1969 legislation adds, in any direct fashion, strength to the Commissioner's position with respect to the pre-1969 debentures issued here. However, it is beyond question that the congressional resolution applicable to obligations issued after May 27, 1969, is, for the most part, parallel to the Commissioner's position in this case.

Respectfully submitted.

ROBERT H. BORK,
Solicitor General.

JANUARY 1974.

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